RCEP/WP no.11/October 2000

OLD AND RESTRUCTURED FIRMS

Arabela Sena Negulescu
Private and Financial Sectors Development, The World Bank

1. Introduction

The restructuring of old firms inherited from the centrally planned system is a key policy issue for the success of transition reforms. It is commonly accepted that failure to restructure at the enterprise level is likely to undermine macroeconomic stabilization efforts, endanger the health of the financial sector, and lead to a reduction of the population's overall standard of living.

Prior to transition, enterprises operated in a highly distorted economic environment. As the transition to a market economy started, state enterprises began to confront hard budget constraints for the first time. This severely limited enterprises' access to sources of both short-term operational as well as longer-term development funds. Enterprises found themselves in a situation where restructuring - adjusting their operations in line with market mechanisms – became of primary importance. The aim of this paper is to assess the extent of restructuring of Romanian enterprises. The evolution of enterprise performance will be presented and some of the factors triggering restructuring and the challenges of implementation will be analyzed.

In order to assess the extent of the changes in performance, three analyses on enterprise financial data of 6,203 enterprises were performed. The objective was to identify the main directions of enterprise performance, measured in terms of profitability, capital utilization and capital structure, as well as changes in infrastructure, legal and regulatory framework and the enabling environment which might have led to restructuring. The analysis will be based on assessing the performance of the selected group of companies for which financial data was available during the period from 1994 to 1997.

The first type of analysis to be carried out classifies the firms into groups based on their cash generating capacity and looks at changes in the structure of the groups.

The second type of analysis considers the aggregate financial data of the group and uses financial analysis tools to spot broad trends in firms' behavior and also to offer explanations for the results from the first section.

To understand the determinants for firm restructuring, the third analysis focuses on the changes in the relationships among firms, on the one hand, and creditors, suppliers, owners and employees, on the other hand. The paper touches upon issues such as restructuring debt contracts, equity contracts and employee contracts.

Finally, some conclusions will be drawn.

2. Old Firms

An OECD economic survey notes that " the starting point for the transition process in Romania was, in many respects, more difficult than in other countries in Central and Eastern Europe. Pre-transition policies emphasized self-dependence, putting excessive focus on heavy industry and large infrastructure projects. This strategy led to the depletion of domestic energy sources and induced inherited costly dependence on imports of energy and raw materials"[1].

Indeed, by standards of most market economies, Romania had a large industrial sector. By the 1980s, 60 per cent of output and 38 per cent of employment were accounted for by industry. In the traditional pattern of socialist industrialization producer goods industries were promoted. By 1989, these accounted for 56 per cent of total industrial output. This specialization was strongly influenced by Romania's position in CMEA. The second largest subsector was chemicals, including oil and petrochemicals, with 21 per cent of the total industrial output. Metallurgy, the third largest subsector, kept its share at about 9.8 per cent of industrial output throughout the 1980s. Like the composition of output, industrial location was determined by political and not efficiency considerations. In many districts one large firm accounted for the majority of employment.

The old firms inherited from the central planning system were highly energy intensive and obsolete. Priority given to new investments other than modernization of the existing capital stock, combined with the decline in equipment imports resulted in a growing obsolescence of Romanian firms.

In 1991, after two years of market reforms, old firms were already corporatized or turned into what were called *regies autonomes*. Thus, about 7,432 commercial companies and 84 national *regies autonomes* were established by the end of 1991[2]. But, some of the characteristics of old firms persisted in the newly corporatized, but still, state-owned enterprises: the limited supply of some key raw materials and energy products, input allocation, and, more importantly, limited decision-making decentralization.

Perhaps one of the most challenging tasks for the Romanian Governments during transition has been the restructuring of this highly distorted economic system. Contrary to other countries, Romania has chosen the "incrementalist" approach for restructuring the old firms. Restructuring was sought along with preserving the existing capital stock, links with suppliers, creditors and employment levels.

Changes in the Performance of Firms

In order to assess the extent of the changes in the performance of firms, two analyses of financial performance on 6,203 enterprises were performed. The objective was to identify the

[1] *OECD Economic Surveys – Romania 1998*
[2] Source: National Bank – Annual Reports 1991 - 1995

main directions of enterprise performance measured in terms of profitability, capital utilization and capital structure for both 1994 and 1997.

Both analyses have concentrated on assessing the performance of the selected group of companies for both 1994 and 1997. The first analysis classifies the firms into groups based on their performance and looks at the changes in the structure of the groups between 1994-1997. The second analysis considers the aggregate financial data of the group and uses financial analysis tools to spot broad trends in firm behavior and to explain results from the first section.

The panel analyzed contains 6,203 firms, including both *regies* and commercial companies. All sectors are represented: industry, agriculture, utilities, etc. The employment in the sample amounts to 2,978,000 employees in 1994 and 2,299,000 in 1997. The sample's total turnover of GDP was about 86 percent in 1994 has decreased to 68 percent as of 1997.

Grouping Firms by their Performance

The ability of the firms to generate positive cash flow from operations is used in this analysis as an indication of firms' restructuring. The distribution of enterprises included in the sample is done based on the following criteria:

Table 1 : Cash Flow Categories

Categories		Cash Flow Generation	Condition
		Profit/Loss from Operations	
	+	Depreciation	
A	=	Gross Cash Flow from Operations	<0
	-	Increase in Working Capital	
B	=		<0
	-	Interest	
C			<0
	-	Exceptional Results	
D			<0
	-	Taxes	
E	=	Net Cash Flow from Operations	<0
F	=	Net Cash Flow from Operations	>0

Thus, firms were categorized according to their performance into six groups.

Group A firms do not generate cash flow from operations ("cash hole companies").

Group B firms generate a positive gross cash flow from operation but not enough to cover the required working capital needs.

Group C firms generate a positive gross cash flow and can cover the working capital needs, but cannot cover interest payments.

Group D firms generate a positive gross cash flow, cover the working capital needs, pay interest, but cannot cover exceptional results[3].

Group E firms generate enough positive cash flow to cover working capital needs, pay interest and penalties, cover the effects of exchange rates, but cannot cover tax payments.

Group F firms generate positive net cash flow from operations and even remain with cash for investments.

In 1994, out of the 6,203 firms in the sample, 3,549 firms were in the best category (F). In 1997 the number of this category of firms increased to 4,228. Table 2 presents the number of firms in each category in 1994 and 1997.

Table 2 : Grouping of Companies by the Degree of Cash Generation

GROUP	***1994***	***1997***
A	401	396
B	961	424
C	952	571
D	117	333
E	223	251
F	3,549	4,228
All Firms	*6,203*	*6,203*

A certain variability in the evolution of performance can be noticed. Thus, only 76 percent of the firms in category F in 1997 are firms which maintained their position since 1994. The rest of the 24 percent were almost equally distributed in lower performance categories.

Also, out of the 401 firms in category A in 1994, only 17 percent remained in the same group, while about 51 percent transferred to group F.

Of the total 6,203 firms, 4,137 firms improved or stayed with the same cash generation performance. In the transition matrix (table 3), the gray area contains the firms which stayed or joined better performing groups.

Of the total labor force employed in the 6,203 firms in 1994, about 22.3 percent had been laid off by1997. Along with the redistribution of firms in the different groups of cash generation performance, a redistribution of the labor force took place. While for the firms in group F the

[3] Exceptional results should not have been included in this analysis; however, in Romania, large foreign exchange adjustments and penalties, the main constituents of the exceptional results, are quite common.

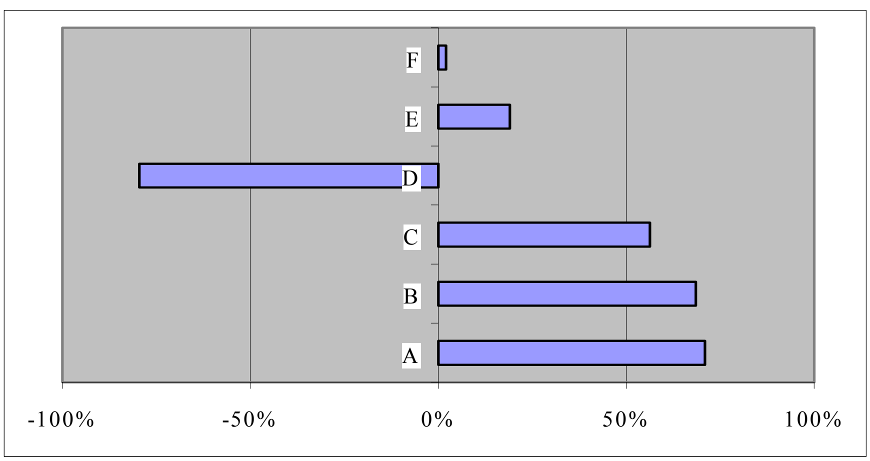
labor force reduction was only by about 2 percent, for firms in groups A, B, and C the reduction was by more than 60 percent (Figure 1).

Table 3 : Transition Matrix 1994-1997

	A *396*	***B*** *424*	***C*** *571*	***D*** *333*	***E*** *251*	***F*** *4,228*	*6,203*
A *401*	17%	8%	14%	8%	1%	51%	100%
B *961*	7%	8%	18%	6%	4%	57%	100%
C *952*	7%	6%	18%	9%	4%	57%	100%
D *117*	7%	9%	6%	13%	3%	62%	100%
E *223*	1%	8%	4%	3%	6%	78%	100%
F *3,549*	5%	6%	4%	4%	4%	76%	100%

This analysis shows that the companies in the panel have improved their financial performance in 1997 compared to 1994.

Figure 1 : Change in the Labor Force by Groups of Firms



The above analysis is largely based on an assumption which many may take as unrealistic in the transition context. So far we implicitly *assumed that the funds for goods or services delivered are actually paid off, and firms that do not pay go bankrupt*. However, this is a seriously limiting assumption in the context of the events of 1994-1997 (and even in the present day). The reality of the situation in Romania is characterized by the large amounts of inter-enterprise arrears accumulated during this period. It should be noted that in the absence of financial discipline, debtors will choose to delay repaying their debts (to benefit from high inflation, among other things) whenever they are able to delay their payments to suppliers, creditors or the state. In what follows, better performance of enterprises in the panel could at least partially be due to the worsening of financial discipline.

However, before jumping to specific conclusions, it is important to check what the composition of net cash flow from operations is. In order to do that, the aggregate data of the firms in the panel will be used to perform a cash flow computation for both 1994 and 1997. For an easier interpretation of all figures they are computed as percentages of turnover. Then, a ratio analysis for working capital management and debt structure elements is undertaken. The analysis performed using aggregate financial data for the firms in the panel shows an improvement in cash flow dynamics.

As Table 4 below shows, firms in the panel had ended 1997 with a positive net cash flow from operations representing 1.92 percent of the turnover. This net cash flow covers working capital changes, financial charges, exceptional charges and the profit tax. In 1994, the same cash flow position was only 0.23 per cent of turnover. The better 1997 cash flow appears despite higher financial, exceptional and tax charges, and it is obviously a result of the small decrease in net working capital, compared to the increase from 1994. This is the difference that has overridden the increases in the other charges and has led to a larger amount of extra cash in 1997 compared to 1994.

Table 4 : Elements of the Net Cash Flow from Operations

% of Turnover	1994	1997	*%Difference*
Gross Cash Flow from Operations	**11.31%**	**12.45%**	***10.10%***
(-) Increase in Net Working Capital	4.03%	-0.02%	*-100.46%*
(-) Net Financial Charges	4.84%	5.88%	*21.52%*
(-) Net Exceptional Charges	0.31%	2.13%	*587.59%*
(-) Profit Tax	**1.89%**	**2.54%**	***33.98%***
(=) Net Cash Flow from Operations	**0.23%**	**1.92%**	***736.42%***

The uses of generated "extra" cash are presented in Table 5. In both years it has covered a small portion of capital investments, with the rest being financed mostly by increases in financial debt. However, the latter use of the cash flow lies outside the scope of current study. Thus, we will in turn focus on cash flows from operations.

Table 5 : Net Cash Flow Utilization

% of Turnover	1994	1997	*%Difference*
Cash Flow from Investments Financed from:	**-8.15%**	**-8.99%**	***10.35%***
Net Cash Flow from Operations	0.23%	1.92%	*736.42%*
Increase in Financial Debt	8.09%	6.33%	*-21.72%*
Other Sources	-0.17%	0.74%	*-531.34%*

The objective is to find out if the better net cash flow from operations is a result of better performance or other causes. For this, each element that composes the net cash flow from operations is further analyzed.

Gross Cash Flow

Table 6 : Gross Cash Flow Decomposition

	1994	1997	%Difference
% of Turnover			
Operating Profit	8.96%	9.18%	*2.42%*
Depreciation	2.34%	3.27%	*39.50%*
Gross Cash Flow from Operations	**11.31%**	**12.45%**	***10.10%***

The gross cash flow from operations represents the aggregate companies' capacity to generate cash from operations. It is composed of operating profit plus non-cash charges (depreciation). Both positions show slight improvements in 1997 (table 6). However, if taken as is, the figure for operating profit may be misleading since it incorporates inflation whenever a company uses FIFO for inventory computation. Additionally, inflation in 1997 has been much higher than in 1994, and most Romanian companies are using FIFO, so it is very likely that 1997 operating profits are overstated. Fortunately, the next position we analyze accounts for this concern.

Changes in Working Capital

Working capital is the part of a company's invested capital used to finance short term day-to-day operational activities. Generally, in the presence of arrears, inventories and accounts receivable are partially covered by non-financial (non-interest bearing) debt to suppliers, the state, and other creditors. The remaining portion of these assets is called working capital and is financed with equity and/or debt. An increase in the level of working capital must be financed with additional cash, while a decrease will free additional cash for other uses. The item called changes in working capital is the one that makes automatic adjustments for inflation, no matter what method is used to account for inventories.

Table 7 : Increase in Net Working Capital

	1994	1997	%Diifference
% of Turnover			
Increase in Inventory	8.49%	8.25%	*-2.85%*
Increase in Receivables	8.85%	8.82%	*-0.36%*
Increase in Gross Working Capital	**17.34%**	**17.07%**	***-1.58%***
Increase in Suppliers	6.40%	8.62%	*34.56%*
Increase in Clients/Creditors	0.57%	0.83%	*46.49%*
Increase in Other Debt	6.34%	7.64%	*20.53%*
Increase in Non-financial Debt	**13.31%**	**17.08%**	***28.39%***
Increase in Net Working Capital	**4.03%**	**-0.02%**	***-100.46%***

In 1994 the increase in net working capital is positive, that is the companies had to use cash to finance it, while in 1997 it has been slightly negative--a small amount of cash has been freed and made available for other uses. We have seen earlier that this was the reason for better net cash flow from operations in 1997.

At this point again, the difference in the change in working capital may have two possible explanations: better current assets management, or worse financial discipline. Since the increase in gross working capital (inventories and receivables) is quite similar in both years, the difference appears from the increase in non-financial debt. Indeed, while the increase in non-financial debt has been 13% of turnover in 1994, it has been 17 percent of turnover in 1997--a difference of almost 30 percent.

The immediate results which can be drawn is that companies have delayed payment of their payables, and therefore have obtained additional means to finance working capital increases. To confirm that, we will decompose the companies' debt structure for 1994 and 1997 into three main categories:

- financial debt;
- current non-financial debt;
- and overdue non-financial debt.

From the two graphs, it appears that the debt structure remained about the same, but an increase by 3 percent of overdue non-financial debt replaced a portion of the financial debt in 1997.

Based on this last evidence, the hypothesis that the increase in non-financial debt is responsible for better net cash flow from operations in 1997 is confirmed.

Therefore, we conclude that the improved cash flow performance is, in fact, due to further increases in the volume of overdue payments (arrears) to both suppliers and the state, and, as a leading cause, to the inability of the environment to enforce some sort of financial discipline.

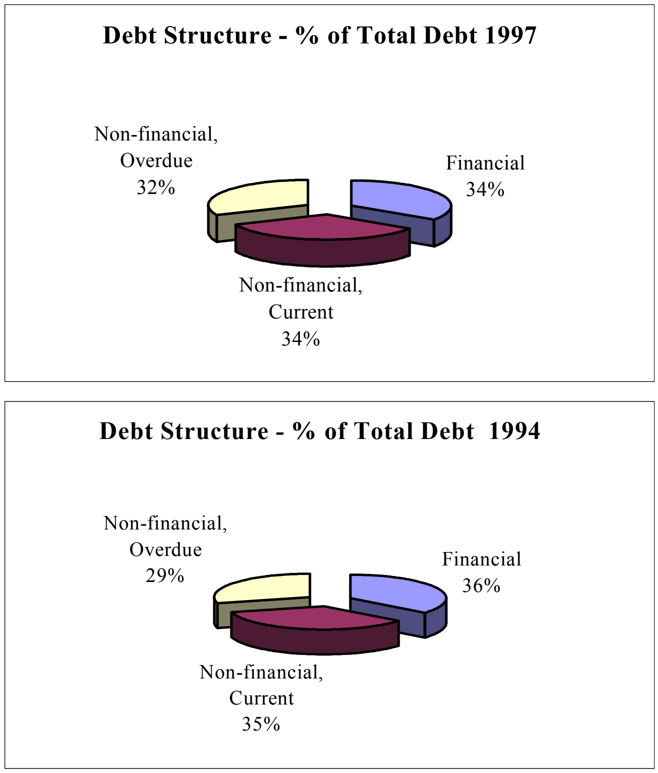
3. Determinants for Restructuring and Challenges in Implementation

Enterprise restructuring does not take place automatically. In order to understand what the determinants are for firm restructuring, we will now focus on the changes in the relationships among firms, on one hand, and creditors, suppliers, owners and employees, on the other hand. An enterprise can be viewed as a set of contracts among individuals[4]. These contracts represent claims on the cash flows generated by the firm's assets and operations. Restructuring can be defined as a process by which firms change the terms of their contracts; therefore, restructuring is about renewing and/or restructuring contracts. Sometimes contracts are restructured through a process of negotiation; other times firms unilaterally restructure their contracts. Economic

[4] Jensen and Meckling refer to this as a nexus of contracts.

restructuring affects the level and the timing of the firms' cash flow; it also affects how the cash flows are divided up and apportioned among the firms' stakeholders. The list of stakeholders

Figure 2 : Debt Structure 1994 - 1997



Includes shareholders, creditors, managers, employees, suppliers and customers.

3.1. Restructuring Debt Contracts

Restructuring debt contracts changes the relationships with suppliers and the different categories of creditors: banks, budget, and others. Firms that are unprofitable or over-leveraged need to restructure their debt contracts. However, the financial crisis observed by most of the state firms has triggered debt restructuring to a limited extent. This may have happened because hard budget and cash constraints were often relaxed and the threat of exit from the market through bankruptcy was not credibly enforced.

Firms were Inherited with Cash Deficits

Under the central planning system that operated in Romania until December 1989, the Government had virtually complete control over enterprise management and finances. The authorities also had complete discretion in determining the tax burden on individual enterprises. Therefore, a distinction between whether state-owned enterprises were actually paying taxes or just transferring the profits to the state budget was not clear.

The tax burden increased during the 1980s as the Government needed to generate large fiscal surpluses as a part of external debt policy. As a result, enterprises were left with inadequate funds to finance current operations and investment, and often with after-tax losses. These losses were financed by extending bank credits. In addition, bank credit was typically extended to clear domestic payment arrears. Therefore, under the centrally planned system there were no enterprise payment arrears as such. The arrears simply showed up as bad debts on the books of the banking system. The reaction of governments to address the payment arrears problem was more targeted to soften the price liberalization shocks.

Blanket Solutions Delayed Restructuring

Starting in late 1990, enterprise payment difficulties appeared in the system. Price and trade liberalization, accompanied by the decline in the domestic and CMEA market, put a serious pressure on old firms to restructure. In late 1991, unpaid bills by these firms mounted to 80% of the total enterprise turnover, and almost twice the level of M2. Arrears of this magnitude created a massive "financial blockage" in the economy. This rapid growth worried the policy makers who felt compelled to "solve the problem" by clearing the stock of enterprise payment arrears.

Thus, a series of selective measures were considered and adopted starting in May 1991, culminating with a generalized scheme, termed "global compensation", which was put into place in late December 1991. Bank credit, partially refinanced by the National Bank, was extended to enterprises to allow them to pay off their overdue debts. Through the motion of serially clearing the debts in linked chains of enterprises, it was intended that the outcome would be achieved without a massive creation of new money. The initial bank credit extended under the scheme was 1,777 billion lei, of which only 186 billion lei was financed by the NBR. All payments were made from special "compensation accounts" and the same accounts were debited with payments received by enterprises. Thus, the gross amount was transformed into a net amount of about 426 billion lei. Because many enterprises that were net creditors to other enterprises were not net debtors to the banking system, much of the new credit went initially toward reducing the overdrafts with banks.

Although considered, in its own terms, a success, the bailing out has not stopped the further rise of enterprise payment arrears. Moreover, it created the wrong expectations that government would be involved in the corporate governance of firms and smoothed the avenue for rent-seeking by politically powerful enterprises. The price paid for this blanket solution was twofold: it delayed restructuring of old firms and deteriorated the asset portfolio of the banks.

Relief to Restructuring –" Isolation" and "Surveillance" Exercises

In 1993 the Government decided that 30 enterprises, among the largest loss makers, be placed under the "isolation" program. The program was designed to provide limited access to bank credits and imposed hard budget constraints. Exit from the isolation regime was through two ways: either divestiture through liquidation or privatization, or significant improvement of the financial situation. By December 1995 only seven companies fulfilled the exit conditions.

In 1995 a new version of the "isolation" program was put into place for 151 firms: the "surveillance" regime. Firms were subject to hard budget constraints, with restricted access to bank credit and state ownership fund support. Their management was expected to design financial recovery programs indicating how they wanted to reduce losses and payment arrears and to restore positive cash flow. All firms under surveillance were closely guided to conciliate payment arrears with banks, state budget and other creditors, and creditors were imperatively asked to accept rescheduling or the writing off of debts.

The outcome of this exercise was that only half of the targeted loss makers met the objectives of the program: 31 firms were privatized, 33 were in the process of liquidation and only 10 had achieved positive operating cash flow by mid-1997. The failure of this program was acknowledged by the Government in 1997.

Several studies[5] have confirmed that isolation and surveillance programs did not deliver any tangible improvements in operational performance, nor did it enhance the privatization and liquidation of large loss-making enterprises that were included in the program. Moreover, they faced softer budget constraints than other enterprises outside the program through access to special funds and government subsidies. Thus, relative to 1992, the situation in 1996 reflects an improvement for the companies outside the program in all aspects. Isolated firms retained a higher employment level (Z-statistic of 4.980 in 1996 as compared to 2.662 in 1992), became less profitable (Z-statistic of –4.679 in 1996 as compared to –1.642 in 1992) and received more budgetary transfers (Z-statistic of 10.524 in 1996 to 7.809 in 1992). It is worth mentioning that overall results in all indicators are driven by the inclusion of the agriculture firms (74 poultry and pig farms). Once this sector is excluded, the 1992 and 1996 differences between the two groups become insignificant.

As in the case of a blanket solution, the government initiating the cancellation or socialization of debt (replacing enterprise debt with government debt) was a dangerous endeavor because it relaxed cash constraints and also invited rent-seeking from the politically powerful enterprises. In the name of "restructuring", restructuring was delayed once again.

The Magnitude of the Problem

Starting in 1990, enterprise payment arrears were evident in the system. The growth of arrears accelerated sharply. By the end of 1991, arrears rose to 1,777 billion, representing about 81% of GDP, and exceeded broad money by 1.8 times. The growth of arrears closely matched the rise in the consumer price level. It appears that the arrears were implicitly indexed to the price level, in that when creditor enterprises were not paid on time they would re-bill the debtor enterprises at the new, higher prices (Figure 3).

After 1992, enterprise payment arrears continued to rise so that, by end 1997, they mounted to 78,649 billion lei. A similar pattern was observed in the state-owned sector. Thus, the stock arrears by the end of 1997 amounted to 41,625 billion lei in the state sector (Figure 4).

[5] "Barriers against restructuring in Romania" – Lucian Croitoru;
"Enterprise Isolation Programs in Transition Economies" - Simeon Djankov

However, the stock of payment arrears in both the whole economy and the state sector had a tendency to flatten out in terms of the price level.

Figure 3 : Arrears, Broad Money and GDP 1990 - 1992

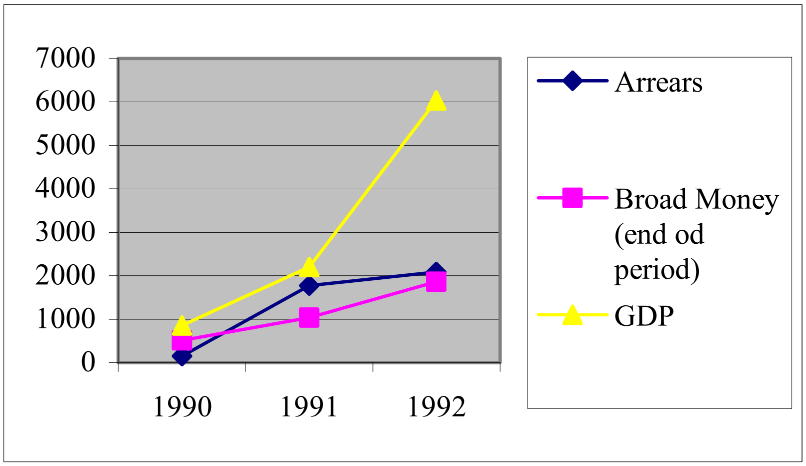
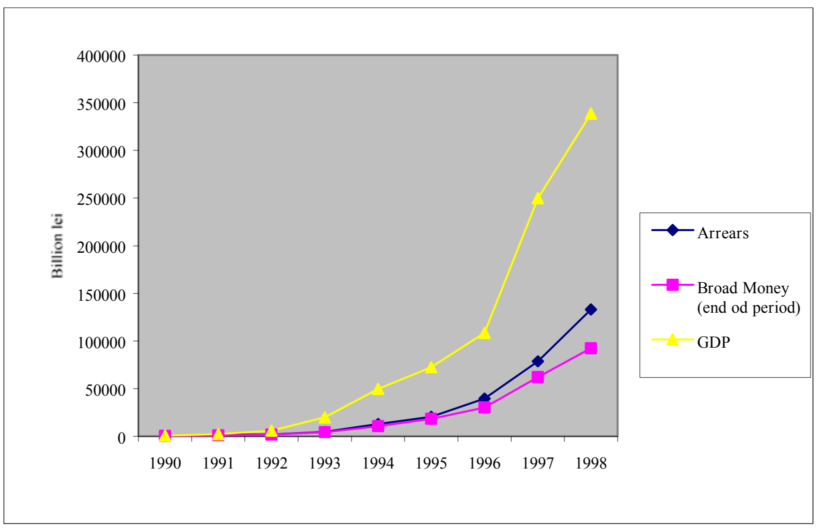


Figure 4 : Broad Money, Inter-enterprise Arrears, and GDP



And Again, Relief to Restructuring

The structure of the payment arrears gives a better picture of the hard budget constraint tightness on enterprises (Figure 5). Inter-enterprise credit declined[6] from 72 percent to 33 percent of the total stock of payment arrears, while arrears to the budget and to other creditors have increased continuously, even in real terms (Figure 6). 56 percent of total arrears in the state

[6] 1995 stocks are understated owing to the write – off of some arrears as part of the debt conciliation in the fall of 1995.

sector were arrears to the state budget and to other creditors (employment, health funds, etc). This reflects a serious relaxation of budget constraints for enterprises from both the budget as well as banks.

Figure 5 : Enterprise Payment Arrears - Real Prices

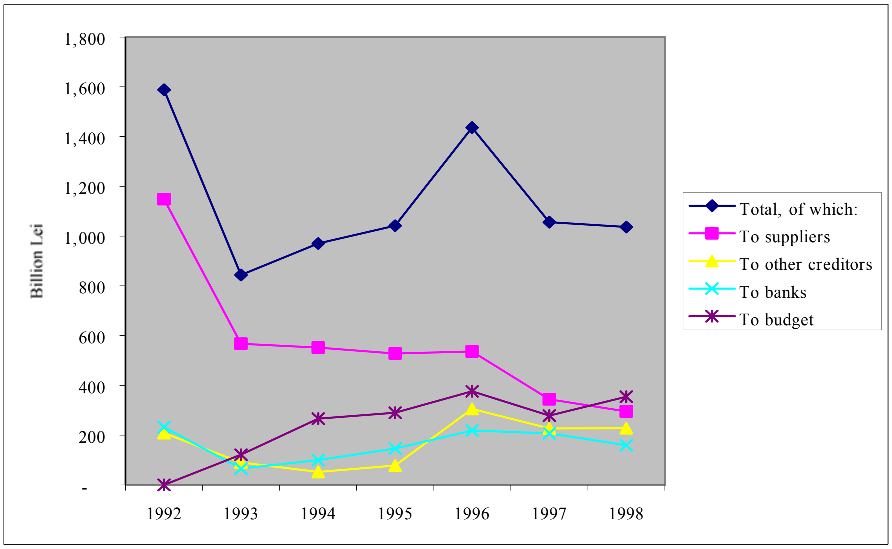
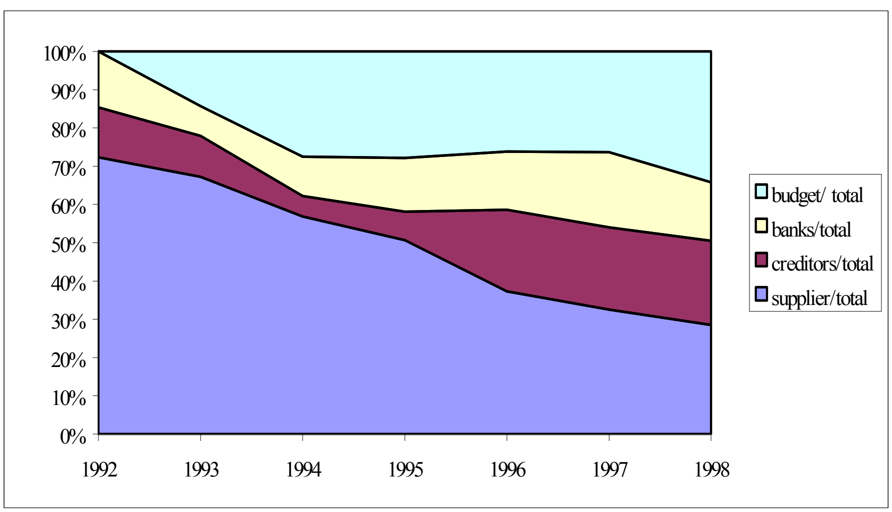


Figure 6 : Categories of the Total Stock of Payment Arrears - Real Prices
Reactions from Creditors



Very often the state, in its twin capacity as owner and creditor, explains the delays in restructuring as largely caused by the inadequate legal framework for bankruptcy, lack of infrastructure (i.e. registries, courts, etc) and problems with implementation. But, at the same time, it was argued that state-owned companies should not be left out of Government "hands". Another argument often used was that administrative decisions to close down operations or to liquidate enterprises should not completely rely on market solutions. Creditors, from the list of which the state was implicitly excluded, should have been the ones to initiate financial reorganization or liquidation procedures.

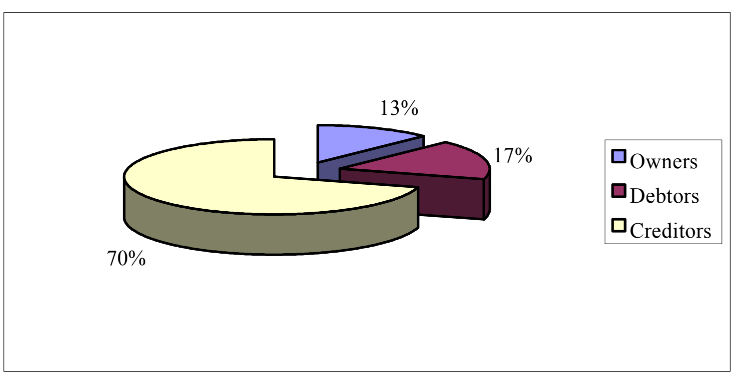
Although there is no need for bankruptcy to close value-subtracting firms, the state-owner very reluctantly has chosen this path. This was done mostly at the pressure of the international financing institutions and covered a low percentage of the loss-making enterprise sector. Only in the last three years has liquidation had some impact, and it was limited to the state ownership portfolio. Thus, by the end of 1998, SOF had divested 171 state companies from its portfolio through judicial reorganization and liquidation. The losses made by these companies represented 32 % of SOF's entire portfolio as of 1997, and 10 % of the losses in all of the state-owned economy.

The state–creditor had a contradictory and unequal reaction. On one side, it tried to enforce hard budget and cash constraints. It penalized and rewarded. However, the net result was that arrears ballooned.

The creditor–suppliers also had slow reactions. There were several reasons for this. First, firms that did not restructure their operations and products had no reason to act upon debtors. Second, the government intervened in business decisions and forced firms to supply, irrespective of payment. Third, arrears to suppliers decreased in real terms which may mean that restructuring is undergoing or simply that cash constraints were relaxed enough by other creditors, such as the budget and the banks

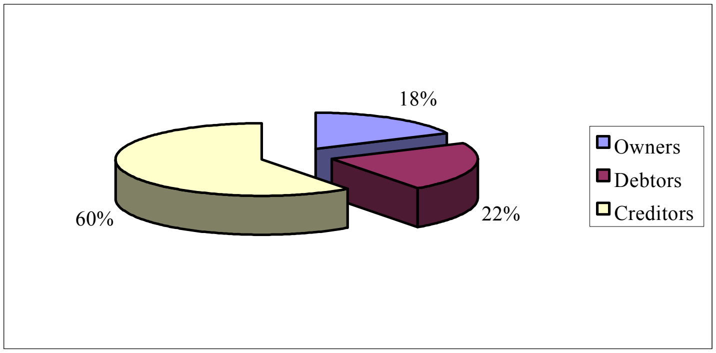
Thus, the total number of state companies under bankruptcy, either through liquidation or financial reorganization, amounts to 358[7] companies with combined assets of more than 7,000 billion lei. Figures 7 and 8 present the liquidations and financial reorganizations initiated by the different stakeholders, listed by the number of enterprises and value of capital stock, respectively.

Figure 7 : Firms in Bankruptcy and Financial Reorganization – by Number



[7] Source: State Ownership Fund

Figure 8 : Firms in Bankruptcy and Financial Reorganization – by Capital Stock



Entry and Exit – A Final Perspective

Hard budget and cash constraints and bankruptcy are the essential driving forces for restructuring old firms. However, they represent only one side of the coin of economic change. The other side is entrepreneurship: new firms. Restructuring without these two essentials can not be enforced. New firms close the resource reallocation circle.

3.2. Restructuring Equity Contracts

Firms can create value by restructuring their equity contracts. Methods for creating new classes of shareholders include ownership changes through takeovers and privatizations. In a Western market economy, the incentive to restructure derives from the presence of markets that reflect discrepancies between the potential and the current realized market value of firms. What triggers equity restructuring is the private claim to the potential increase in value; either a firm would defensively restructure itself in response to the decline in its value, or outsiders, whose perceptions of a firm's potential profitability exceeds the current market value, decide to purchase part or all the firm and undertake restructuring.

Obviously such ability of the market to impose discipline on enterprises is not present yet. Although most of the state firms are potentially tradable on the capital markets, only fractions of their equity are being actually traded. These equity fractions are not large enough to offer a controlling position in the firms. Although the state has the possibility to sell its shares on the capital markets, it vary rarely chooses to do so and only for residual positions. Therefore, takeovers are very limited. Threats to takeover firms are not credible, and thus, the expected effect on firms' restructuring is almost null.

Privatization of state firms started in 1992. There have been eight years of transition and yet only 6,208 companies have been privatized. They represent about 37.5 percent of the initial stock portfolio of the State Ownership Fund, and about 20 percent of the stock of all state-owned enterprises, including *regies*.

We have tried to find a correlation between improvement in performance and change of ownership. From the panel of 6,203 firms analyzed previously, 4,228 firms were found to have a positive cash flow from operations (group F). About 58 percent of the group F firms are firms where the state has sold at least the controlling position (33 percent of the equity). In about 40 percent of the firms in group F, the state has retained a minority position. The results are not conclusive to explain the positioning of firms in group F by the change in ownership.

3.3. Restructuring Employee Contracts

The legacy of the misallocation of all resources, including labor, made restructuring of old firms very difficult. Firms inherited from the central planning system were usually overstaffed as compared to similar companies even from the other former socialist countries. Labor costs represented one of the largest expense categories for most of these firms. Although wages were quite low, the high number of employees raised labor costs to significant levels.

The pressures to restructuring (the cost structure) of the firms determined invariably lowering down labor costs. Different alternatives had to be used for controlling these costs, including layoffs, negotiated wages, and voluntary early retirement programs. All these alternatives were in fact ways to restructure employees contracts. While undertaking such restructuring, managers had to consider some of the characteristics of these contracts. First, employee contracts are less formal than debt contracts or equity contracts, so to a certain extent, they are easier to restructure. Second, employees are a factor of production. Layoffs and wage reduction can indirectly impact a firm's profits through changes in employee productivity and morale. But also equally important was the constant political interference when layoff decisions were made.

One of the most significant indicators testifying to the existence of an initial restructuring of old firms is the decline by 23.6 percent of employment in state industries from 1989 to 1992. However, this labor adjustment was different across industries. Large adjustments occurred in textiles, machinery, equipment, instrument and furniture manufacturing. The low level of adjustment in other industries, such as coal mining, petroleum, natural gas, and utilities was explained[8] by the role of government policy variables in influencing the employment behavior of the firms. Thus, industries receiving subsidies and those in which *regii autonomes* are more present were less likely to adjust. Also, evidence was provided that a pattern of favoritism in some unmeasurable dimensions is responsible for inter-industry differences in the degree of employment adjustment.

One of the industries where the restructuring of employee contracts was difficult and in turmoil is the mining industry. Miners have historically had preferential status, high wages and political influence. Until 1997, the downsizing of the labor force was mainly a result of the natural decline. But the change in governmental policies towards this industry in 1997 through the transformation of the regies into commercial companies and the imposition of hard budget constraints through subsidies reduction triggered the restructuring of this industry as well. The preferential status of the miners was observed again when the government designed the instruments to enforce employee contract restructuring. Thus, about 82,500 miners, representing about 44 percent of the labor force in the mining sector in 1996, accepted voluntary layoffs

[8] "Aggregate Labor Market Behavior in the Restructuring of the Romanian Economy" – John Earle and Gheorghe Oprescu

against severance payments amounting to up to 20 times their monthly net salaries. The position of the trade unions on the change of employment terms for the 82,500 miners was contradictory. Although unions accused the government that it was the one triggering the layoffs of so numerous a labor force, in practice however, they were actively involved in the implementation of such policy. Later on, any involvement was denied and the government was accused of creating " chaos and disaster"[9] in the mining industry.

The net results of this restructuring remain unclear. While the reduction of the labor force was about 44% as compared to 1996, the reduction of the labor cost in total operating costs remained about the same (Figure 9 and Figure 10).

Figure 9 : Cost of Labor/Total Operating Cost

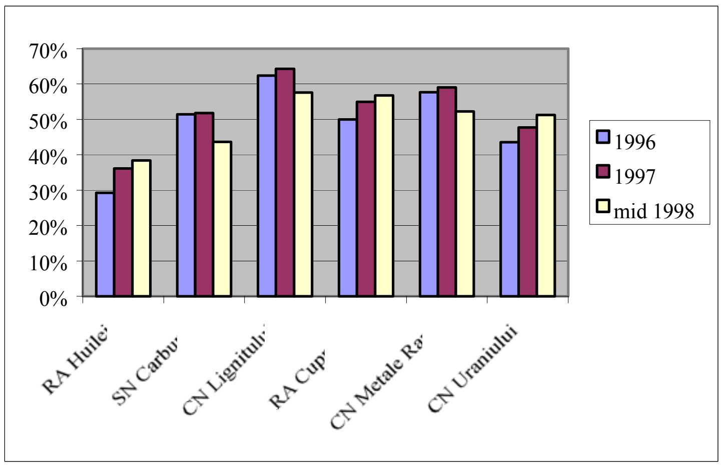
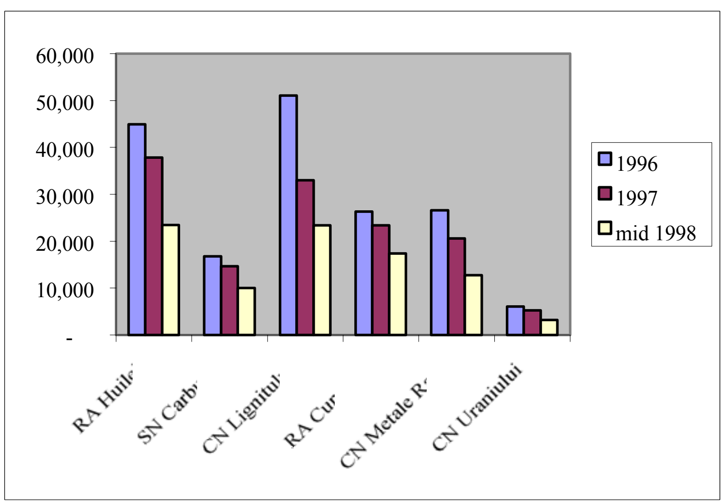


Figure 10 : Labor Force Reduction



[9] "With Miners Eyes" - M. Larionescu, C.Rughinis, S. Radulescu

In addition, table 8 presents an overview of the financial performance in the mining sector over 1996 to 1998 as well as the impact of the employee contract restructuring.

Table 8

The mining companies represent an important share of the losses before subsidies incurred by the state-owned sector. Thus, in 1996 they represented 20.3%, in 1997 around 19% and by mid-1998 about 29.9%. Although important measures aimed to cut costs were taken during 1997, such as the closure of 76 mining operations followed by collective layoffs (81,500 employees), the financial performance of the mining companies continued to deteriorate. The only exception is the National Company of Lignite Tg. Jiu which recorded a small profit.

The losses from operations have been reduced in real terms. The losses/GDP of the mining companies increased from 0.57% in 1996, to 0.71% in 1997 and 0.86% by mid-1998. However, it should be noted that the losses from operations/GDP *decreased* from 0.36% in 1996 to 0.19% in 1997 and 0.20% by mid-1998. That means that during 1997 a *reduction of the losses from operations of about 47% in real terms* took place.

Significant cost reduction measures were taken, but they were practically offset by the increase of salaries on one hand and the decrease of revenues on the other hand. The deterioration of the financial situation in 1998 is due to several causes. The revenues decreased as a consequence of a demand decrease by 25 - 30% and of the lack of price adjustments to reflect the lei's depreciation during the second part of 1997 and 1998. On the cost side, although the employee numbers were reduced by 47%, the cost of labor in total operating expenses increased from 50% in 1996 to 51 % by mid-1998. These factors together created an increase of operational loss per employee by more than 120%.

The total losses/GDP are four times higher than the losses from operation/GDP. With only one exception, the Lignite Company, all the other mining companies have negative cash flows from operations. Therefore, the financing of operations is done by delaying payments to creditors and especially to the state budget. The penalties and interest create the accumulation of *huge losses from exceptional activities*.

Huge power of the customers, and especially of Conel, further deteriorates liquidity. The lack of liquidity is further aggravated by the way Conel (the electricity company) is paying the bills for coal purchased. The payment is not done in cash, but in so called "bilete de compensare" (compensation notes). At the most, Conel pays cash for only the amount necessary for the mining companies to cover their salary bill. Therefore, very often, there is *no cash left for paying taxes to the budget*.

4. Conclusions

The restructuring of old firms inherited from the centrally planned system is a key policy issue for the success of transition reforms. What can governments do to speed up the restructuring of these firms? From the analyses presented in this paper, several conclusions can be drawn which may address this question.

First, an increased number of firms are performing better in 1997 as compared to 1994. However, it was shown that the improved cash flow generation performance is, in fact, due to a further increase in the volume of overdue payments to both the suppliers and state.

Second, the financial crises observed by most of the firms was triggered to a limited extent by debt restructuring. Hard budget constraints have been acknowledged to be vital by different governments but enforcement has been contradictory. Blanket solutions to arrears problems relaxed the cash constraints on enterprises. Case by case solutions, as the "isolation" exercise was, have proven to be a "hospital" rather than a "jail". Moreover, the state has played conflicting interest positions, being creditor, owner and debtor at the same time. Therefore, bankruptcy could not have become a credible threat for companies to restructure themselves.

Third, the presence of these firms on the capital markets was almost null. Threats to taking over firms were not credible, and thus, the incentive to restructure which should have come from the private claim to the potential increase in value, could not be exercised.

Fourth, the restructuring of employee contracts has proven difficult and produced unclear results. Although less formal than debt contracts or equity contracts and thus easier to restructure, constant political interference when employees layoff decisions occurred made the restructuring of such contracts sensitive to implement.

References

OECD An Economic Assessment 1993

OECD Economic Surveys 1998

Gerhard Pohl, Robert E. Anderson, Stijin Claessens, Simeon Djankov, 1997 . Privatization and Restructuring in Central and Eastern Europe . World Bank Technical Paper no. 368

Gerhard Pohl, Robert E. Anderson, Simeon Djankov, 1996 – Restructuring Large Industrial Firms in Central and Eastern Europe: An Empirical Evidence

Stijin Claessens, Simeon Djankov, Gerhard Pohl, 1997 - Determinants of Restructuring in Seven European Transition Economies

Joseph E. Stiglitz , 1999 - Whiter Reform? Ten Years of the Transition. Paper prepared for the Anual Bank Conference on Development Economics

John Earle, Gheorghe Oprescu - Aggregate Labor Market Behaviour in the Restructuring of the Romanian Economy

John Nellis, Sunita Kikeri, Mary Shirley, 1992 – Privatization: The Lessons of Experience

Lucian Croitoru, 1996 - Bariere in Calea Restructurarii Intreprinderilor de Stat in Romania , CPSCA

S. Ramanchandran, 1995 - Bankruptcy's Role in Enterprise Restructuring: A Hammer to Turn a Screw? World Bank Public Policy for the Private Sector

Timothy Condon, S. Ramachandran , 1995 - Cash Constraints and credit Corset: The Chimera of Interenterprise Credit . World Bank Public Policy for the Private Sector

Wendy Carlin, Michael Landesmann, 1997 – From Theory into Practice? Restructuring and Dynamism in Transition Economies, Oxford Review Economic Policy, Vol 13, No.2